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C O N F I D E N T I A L SECTION 01 OF 04 JAKARTA 003160

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STATE FOR EAP/MTS AND EEB/ESC/IEC/EPC-GRIFFIN
DOE FOR TOM CUTLER/PI-32 AND C. GILLESPIE/PI-42
COMMERCE FOR 4430-BERLINGUETTE

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SUBJECT: RESOURCE NATIONALISM IN INDONESIA

REF: A. A) STATE 150999 (RESOURCE NATIONALISM)
¶B. B) 06 JAKARTA 05217 (SBY AND ECONOMIC NATIONALISM)
¶C. C) 06 JAKARTA 13253 (GOI SEEKS BETTER NATUNA TERMS)

Classified By: Classified by Ambassador Cameron R. Hume. Reason: 1.4(b, d)

¶1. (C) Summary. Indonesia has a long history of tension between economic nationalists and those who welcome foreign investment. However, our contacts report no upsurge in resource nationalism-inspired actions. Indeed, the increase in resource nationalism described in ref A has benefited Indonesia,s petroleum sector as foreign investors have given Indonesia a second look after receiving unreasonable treatment elsewhere. In practice, foreign investors in the extractive industries have long been able to participate only as contractors for the Government of Indonesia (GOI). U.S. firms complained to us regarding contract terms and bad faith negotiations until late 2005. Since 2005 the GOI has actually been more generous with contractor splits to entice foreign upstream investors. The GOI has generally respected deals once signed, despite vigorous protests by opposition politicians and activists. State oil company Pertamina is the primary beneficiary of resource nationalism in the petroleum sector but lacks the technological skill to capitalize on its privileged status. In the mining sector, cabinet minister Aburizal Bakrie has been most successful in using nationalism for his private personal gain. End summary.

OPEC,S Only Net Importer

¶2. (SBU) Indonesia is East Asia,s only OPEC member. But it became a net oil importer in late 2004 due to years of lack of investment in exploration and production. In 2006, Indonesia ranked twenty-first among world oil producers and eighth in natural gas. The turmoil of the 1997-1998 Asian Financial Crisis took a heavy toll on the extractive industries. Indonesia,s share of global petroleum exploration and production spending plunged from eight percent in 1998 to less than one percent in 2005. Crude production continued its multi-year decline to an 11-year low with 976,500 barrels of oil per day (bpd) in 2006. In April 2007 monthly output dropped below 850,000 bpd, a level not seen since the early 1970s. President Susilo Bambang Yudhoyono (SBY) came into office pledging to reverse the trend to achieve a 1.3 million bpd production target.

¶3. (SBU) Many of the problems that U.S. extractive industry

companies face here reflect problems with the overall investment climate. Working with the GOI, Parliament, business, labor, and NGOs to promote reforms in this area is among the USG,s top priorities here. U.S. firms continue to express a high degree of frustration with the opaque and lethargic decision making by GOI regulators, but they no longer express dissatisfaction to us over the financial terms of their deals. One American executive told us recently, &It is not necessarily that Indonesia has gotten any better. It is just that the rest of the world has gotten worse. It is hard to get a deal done here but they generally stick to it once it is done.8

Hardy Perennial: Indonesian Economic Nationalism
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¶4. (C) The legacy of harsh colonialism by the Dutch for over three hundred years has left many Indonesians with a distrust of foreign motives, especially in economics and business. Under Soeharto, business was the business of Indonesia, but free-market capitalism was not necessarily welcome. During his long rule, Soeharto,s government created thousands of state-owned enterprises (SOEs) in every sector of the economy. Even today, the GOI has more than 150 SOEs, many of which play large roles in key sectors. State oil Pertamina is still the crown jewel for many economic nationalists here. Foreign oil companies have been in Indonesia for more than 60 years, and the GOI had long required them to cut Pertamina minority stakes. The company used to serve as little more than the cash box for Soeharto and his cronies. It developed little technical expertise, preferring to collect royalty payments. The legacy of SOEs and mandatory local partners for foreign companies has created throughout the entire

society--and especially so in the resource sector--a rent-seeking mentality. Elite Indonesian economic actors have long focused on securing their 5 to 15% minority stakes in foreign joint ventures, whether in mining or oil or travel agencies or advertising firms. As a result, a Chavez-wannabe in Indonesia would encounter fierce resistance from an army of politically connected professional intermediaries, whose parasitic existence depends on foreign energy and mining firms.

¶5. (C) Now that Indonesia is a genuine democracy, a nascent populism mingles with the old vestiges of economic nationalism. Former People's Consultative Assembly Chairman Amien Rais is the most prominent politician waving the flag of economic nationalism in hopes of strengthening his likely presidential bids in 2009 and stirring up trouble for SBY in the meantime. In 2006 Rais and several other prominent political figures issued a broadside in the form of a public letter attacking SBY for the GOI deal with ExxonMobil (EM) to develop the Cepu oil and gas field. The group also criticized Freeport,s continued mining operations in Papua. The open letter offered a mixture of incorrect facts, misrepresentations of the truth, muddled thinking, irrational economics, and tried and true economic nationalist grievances. Rais frequently makes public statements that Freeport pays no taxes or royalty payments in Indonesia from the Grasberg copper and gold mine in Papua. Freeport executives tell us they have met repeatedly with Rais to show him their tax and royalty receipts, which equaled 1.5% of GDP in 2006. We expect to see a continued upsurge in this populist form of economic nationalism as we get closer to the 2009 election.

Foreign Oil Companies Bear All Risk

¶6. (SBU) Under Indonesia,s 1945 Constitution all natural resources belong to the people. In practice this means that foreign investors in the extractive industries may participate only as contractors for the Government of Indonesia (GOI) in return for a percentage of the profit.

Production Sharing Contracts (PSCs) are the principal way through which the GOI regulates oil and gas exploration in Indonesia. With the passage of the Oil and Gas Law in 2001 the GOI moved away from other models of cooperation (Technical Assistance Contracts, Enhanced Oil Recovery Contracts, and Technical Evaluation Agreements) to put all new developments into the PSC model. PSCs generally have a 30-year term for new investment and may be extended for another 20. Contractors bear all the risks and costs for exploration and may recover their expenses only from commercial production. PSC contractors obtain an after-tax equity share of 15% (more in higher risk frontier areas and as high as 35% for natural gas) after recovering their exploration costs and investment credits. In practice, however, a foreign company with several PSC areas earns a return of less than 15% on the recovered oil since they earn no cost recovery or tax deductions for unsuccessful wells.

¶7. (SBU) PSCs also have long featured a Domestic Market Obligation (DMO) under which contractors were required for a time period defined in their contract to sell 25% of their production to the Indonesian market at reduced prices. In January 2006, Energy Minister Purnomo announced a new natural gas policy reorienting the then-world,s largest LNG exporter to serve primarily domestic needs. Purnomo also announced that PSC contractors would be required to sell &up to 25%8 of the production domestically at prices far below market bench marks. The GOI has been unwilling since that time to clarify whether this represents a ceiling or floor. The lack of clarity has caused much angst among IOCs. To be sure, the GOI continues to honor its current LNG export contracts. As they have diverted natural gas to local use, the GOI has been forced to go on the spot market to purchase LNG for delivery to its South Korean and Japanese buyers at a cost of almost $2 billion during the last two years, according to our industry contacts. The GOI has told their foreign buyers that they cannot expect to have their LNG contracts renewed as they expire over the next six years.

¶8. (C) The protracted negotiations between ExxonMobil and the GOI over the development of the Cepu oil field typify the tension in Indonesian economic policy making between the

necessity to attract foreign capital and a deep ambivalence and suspicion toward international investors, according to many of our energy contacts. On March 15, 2006, EM and state oil company Pertamina concluded more than four years of negotiations on the joint operating agreement for the Cepu block in East Java. EM will invest more than $2 billion in the project, which will hit peak production of 171,000 bpd in 2010, representing an increase in national output of 15 percent. EM executives told us that they found the negotiations to be painful and frustrating. They say they concluded the deal only after they made high-level representations personally to President Yudhoyono, who had to replace the board and CEO of Pertamina to get the deal done. EM executives also told us that the GOI showed much greater flexibility in negotiations in advance of important high level USG-GOI meetings, perhaps suggesting an important means of combating the tendency toward economic nationalism here in Indonesia.

¶9. (C) Currently, the two sides are again squared off over the huge Natuna off-shore natural gas deposit (Ref C). The contract could become a major source of contention. As of now, however, the company has not sought our active support, besides finding opportunities to raise it with GOI policy makers when the opportunity arises. Our EM contacts say the negotiating dynamic is similar to that of the Cepu negotiations and no different now than when oil was trading at $20 per barrel. The Natuna field was discovered more than 35 years ago but has lain dormant due to the high CO_2 content of the gas and the remote location of the field. The two sides continue to haggle over the field operatorship and financial percentages. In both the Cepu and Natuna

negotiations, the GOI has sought increased shares for Pertamina financially but the main emphasis has been on giving Pertamina personnel the skills and knowledge to function as a real exploration and production company. Under Soeharto, Pertamina was little more than a giant cash box for the dictator and his cronies. The company had little technical know-how and few personnel who could manage a large-scale development. GOI contacts tell us they are determined to replicate the success of next door neighbor Petronas from Malaysia, which has the skills and balance sheet to do complex, major oil field projects.

¶10. (C) Chevron and ConocoPhillips report no more than the usual decade-old headaches associated in dealing with the GOI energy bureaucracy. In fact, Marathon Oil and Anadarko returned to Indonesia in the last three years in response to the reformist signals sent by SBY,s administration. All our companies continue to express frustration with the pace and transparency of decision making by GOI regulatory officials, but they find no connection between resource nationalism and the lackluster tempo of bureaucratic decision making. Our contacts say the biggest stumbling block to greater foreign investment here is the GOI,s inability to coordinate tax policy on the temporary import of drilling equipment, which also far pre-dates the recent years of surging oil prices. Our contacts believe that the intransigence may stem partially from resource nationalism, but is more likely rooted in the desire of bureaucrats to avoid causing losses to the state treasury, which is equivalent to bribe-taking under GOI law.

Mining More Susceptible to Populism

¶11. (C) Mining projects, which require less sophisticated technology and less capital investment than petroleum projects, seem to attract comparatively more attention from economic nationalists. Despite a global commodities boom, Indonesia has seen only $800 million per year in foreign and domestic mining investment from 2000 to 2005, according to GOI figures. Since the late 1990s, Indonesia has regularly been singled out by an authoritative global survey for having one of the worst investment climates for mining. This same survey also regularly notes that Indonesia is one of the most geologically prospective countries in the world. Fears of poor treatment are holding up $11 billion of investment, according to the Indonesian Mining Association. The most prominent example of resource nationalism in Indonesia has been Bumi Resources,s acquisition of Kaltim Prima Coal (KPC) during 2001 through 2003 from a joint venture of BP and Rio Tinto.

¶12. (C) Bumi Resources belongs to the parent company of current Coordinating Minister for People,s Welfare Aburizal Bakrie, one of the richest men in Indonesia. Under Indonesia,s Contract of Work system, foreign companies must over a specified number of years divest a majority of the equity stake of each mine to the GOI or Indonesian partners. Under foreign ownership KPC suffered from an abnormally and suspiciously high amount of labor strife, according to industry watchers. As a result, instead of divesting small minority stakes over many years as required by GOI law, the joint venture partners ultimately decided to sell 100% of the company over only three years. Bumi paid $685 million for KPC and another coal company in 2003. Our contacts at the time told us these deals undervalued the companies at pennies on the dollar. In 2007, Bumi spun off 30 percent of KPC to India,s Tata Group in a deal which valued the firm,s coal assets at $4.3 billion. Bumi executives have openly told us and Wall Street investment road shows that they hope to repeat such &value-oriented8 acquisitions in the future with respect to Newmont Mining,s Indonesian assets.

¶13. (C) The Newmont divestiture process is ongoing and

currently poses no immediate risk to U.S. interests here. Newmont is negotiating with several friendly Indonesian parties about acquiring minority shares. However, again, should Bakrie,s Bumi Resources seek to mount an unfriendly takeover in the manner in which it acquired KPC, it could become an investment dispute of importance to the USG. Our message on this question is for an open and transparent divestiture process, not a change in the current divestiture requirement.
HUME